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## TAX CONSEQUENCES OF PAYMENTS TO WIDOWS AND SECTION 126

Melvin Stanley Flechner\*

It seems that sleeping dogs are always disturbed in the field of taxation. After much litigation, bureau rulings and writings on the intriguing problem confronting widows, heirs of deceased employees who are the recipients of payments and the employers who make these payments we now have I.T. 4027<sup>1</sup> which arouses our sleeping dog.

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1. "Payments made by an employer to the widow of a deceased officer or employee, in consideration of services rendered by the officer or employee, are includible in the gross income of the widow for Federal income tax purposes." O. D. 1017 (C.B.-5 101 [1921]) revoked and I. T. 3329 (C.B.-2 153 [1939]) modified. In O. D. 1017 *supra* it was held that a payment by a corporation to the widow of a deceased officer, equal to the salary which the deceased officer would have earned in two months, was without consideration, a gratuity voted as a compliment to the deceased and that the payment did not constitute taxable income. In I. T. 3329 *supra* it was held that payments made by a corporation to the widow of an officer-stockholder, even though made without contractual obligation, are deductible by the corporation as business expenses and that such amounts are gifts to the widow and not taxable income to her. It is stated in I. T. 3329 that "When an allowance is paid by an organization to which the recipient has rendered no service, the amount is deemed to be a gift or gratuity and is not subject to Federal income tax in the hands of the recipient." Section 29.22 (a)-2, REGULATIONS 111, reads in part as follows: "However, so-called pensions awarded by one to whom no services have been rendered are mere gifts or gratuities and are not taxable." Prior regulations of the Bureau contained the same provision.

It is believed that the above-quoted provision of the regulations was misapplied in I. T. 3329, *supra*. Whereas the regulations stress the position of the payor, that ruling incorrectly emphasizes the position of the payee. The regulations are not applicable if services have been rendered to the person making the payments. The fact that the recipient of the payments did not render such services is immaterial. The principle contained in the regulations is brought out in *Amy H. Varnedoe v. Allen*, 158 F.2d 467, 469 (5th Cir. 1946), *cert. denied*, 330 U.S. 821, 822 as follows:

If the payments to the taxpayer were not mere gifts or gratuities, under the above-quoted exception (the above-quoted regulation), awarded by one to whom no services have been rendered, they are taxable. *It is not necessary that the services should have been rendered by the payee. The payor is the one to whom the services must have been rendered.*

Thus, the essential factor is whether services were rendered to the employer, not, as indicated in I. T. 3329, *supra*, whether services were rendered by the recipient. The type of situation intended to be covered by the regulations is exemplified in L. O. 1040 (C. B.-3 120 [1920]). In that opinion it was held that payments by the Carnegie Foundation for the Advancement of Teaching, made to teachers and their widows and *not based on any service to the foundation*, are non-taxable gifts. The foundation was not the employer of any of the recipients-teachers or their widows.

In some instances it has been held that payments after the death of the employee-husband to his widow by an employer constitute taxable income on the ground that a definite contractual obligation existed to make such payments. The good will of the employee and his faithful service are deemed to be consideration for such payments and give rise to an obligation which may be enforced by the widow. A definite contract existed between an employer and a deceased husband in *Flarsheim v. United States*, 156 F.2d 105 (5th Cir. 1946). In the *Varnedoe* case, *supra*, monthly payments were made to the widow of a city fireman pursuant to a Georgia statute, and the court there held

While the primary purpose of this article is to discuss the tax consequences of payments received by the widow and heirs of the deceased employee, the deductibility of such payments by the former employers bears some discussion.

If the subject of taxation adhered to the legal and logical doctrine of symmetry, the treatment of one transaction between two or more parties would be the same. A payment to an employee by an employer should be considered either compensation for services, deductible by the employer and taxable to the employee, or a gift to the employee and as such not deductible to the employer and not taxable to the employee. Such an item should not be considered as compensation for services deductible to the employer as an expense and at the same time a gift to the employee and not includible in his taxable income.

The Supreme Court in *Bogardus v. Comm'r*<sup>2</sup> stated, "the court below thought that payments such as here involved may be at once 'gifts' under § 22, subdivision (b) (3), 26 U.S.C.A. 22 (b) (3) and note, and 'compensation for personal services' under subdivision (a). Such a view of the statute is inadmissible and confusing. The statute definitely distinguishes between compensation on the one hand and gifts on the other hand; the former being taxable and the latter free from taxation. The two terms are and were meant to be mutually exclusive; and a bestowal of money cannot under the statute be both a 'gift' and a payment of compensation." The validity of the principle of equal treatment of parties to a transaction is clearly based on consistency<sup>3</sup> and logic. Nevertheless, it has been repeatedly disregarded. The Regulations and Income Tax Rulings which deal with the subject at hand violate the above mentioned principles.<sup>4</sup>

Section 23 (a) of the Code allows as a deduction "all ordinary and necessary expense paid or incurred during the taxable year . . . including

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that since the widow had a statutory right to the money, she was taxable with respect thereto under § 22 (a) of the Internal Revenue Code. In I. T. 3972 (C.B.-2 15 [1949]), the "ordinary death benefit" received by the widow of an employee of the Government of the territory of Hawaii, pursuant to Hawaiian law, was held to constitute taxable income. However, it has been held that even where the employer's plan for payments after the death of an employee is a voluntary plan, a contractual obligation exists. See *Mary Sutro v. United States* (an unreported case), decided June 2, 1942 by the United States District Court for the Northern District of California; see also I. T. 3840 (C.B.-1 7 [1947]). It is the position of the Bureau that irrespective of a "plan", voluntary or involuntary, definite or indefinite, payments of the type herein considered constitute taxable income, and it is held that payments made by an employer to the widow of a deceased officer or employee, in consideration of services rendered by the officer or employee, are includible in the gross income of the widow for Federal income tax purposes. Accordingly, O.D. 1017, *supra*, is revoked, I.T. 3329, *supra*, is modified, and the paragraph entitled "Gratuity" in Part I of TREASURY DECISION 2090, approved on December 14, 1914, will no longer be followed. Under authority contained in § 3791 (b) of the Internal Revenue Code, this ruling will not be applicable to payments received prior to January 1, 1951.

2. 302 U.S. 34 (1937).

3. *Merchants National Bank*, 6 B.T.A. 1167 (1927); *John I. Chipley*, 25 B.T.A. 1103 (1932).

4. REGULATIONS 111 §§ 29.22(a)-2, 29.23(a)-9 and I.T. 3329, see note 1 *supra*. The Commissioner seems willing to violate this principle in any case where the revenue can be increased.

a reasonable allowance for salaries or other compensation for personal services actually rendered." A payment received as compensation for services is taxable as income though made without consideration and hence for many purposes a gift.<sup>5</sup> To hold that every payment which in any respect is a gift is perforce not compensation and hence relieved of any tax, is to work havoc with the law.<sup>6</sup> What controls the determination of whether a payment is a gift or compensation is the intent with which such payment, however voluntary, is made.<sup>7</sup>

Very important, too, is the fact that directors of a corporation, as a general rule, have no power to give away any of the assets of the corporation, and here the payment was not submitted to a stockholder vote. If the directors could not give this sum, and the books of the corporation show that it was not given away, it must be presumed that the payment was not a gift.<sup>8</sup>

"A gift is a voluntary transfer of his property by one to another, without any consideration or compensation therefor. Although it is held that the motive accompanying a gift is not material, gifts usually proceed from the generosity of the giver; and, where there is any doubt as to the nature of the transaction, the absence of such motive is a pertinent circumstance for consideration. It is an essential characteristic of a gift, however, that it be a transfer without consideration. If there is a consideration for the transaction it is not a gift."<sup>9</sup>

As early as 1914, the Treasury Department issued a ruling<sup>10</sup> which provided that payments of salary to an officer or employee paid for a limited period after his death to his widow in recognition of the services rendered by her

5. *Old Colony Trust Co. v. Comm'r*, 279 U.S. 716, 730 (1929). Benefit done without legal obligation is in a broad sense a "gift" but when provisions of income tax statutes are construed together, present or former employees to whom money is paid in consideration of their services receive it as "compensation for services" although not demandable and it is taxable income to him. The court thereupon referred approvingly to *Noel v. Parrott*, 15 F.2d 669 (4th Cir. 1926) where compensation payments made to the officers who were resigning from the company were taxed, although a resolution referred to the payments as a "gratuitous appropriation". *Simpkinson v. Comm'r*, 89 F.2d 397, 399 (5th Cir. 1937).

6. *Bogardus v. Comm'r*, 302 U.S. 34 (1937), dissenting opinion by Brandeis, Stone, Cardozo and Black. Categories of a "gift" and "compensation" are not always mutually exclusive, but at times overlap. What controls is not the presence or absence of consideration. What controls is the intention with which payments, however voluntary, have been made. Has the payment been made with the intention that services rendered in the past shall be requited more completely though full acquittance has been given? If so, it bears a tax. Has it been made to show good will, esteem or kindness toward persons who happen to have served, but are paid without thought to make requital for the services? If so, it is exempt. *Weagart v. Bowers*, 57 F.2d 679 (2d Cir. 1932); *Schumacher v. United States*, 55 F.2d 1007 (Ct. Cl. 1932).

7. *Bass v. Hawley*, 62 F.2d 721, 723 (5th Cir. 1933). "The intent is that all receipts in whatever form that come because of labor and service whether payment could be compelled or not shall be taxed as income arising from labor. That only is a gift which is purely such, not intended as a return of value or made because of any intent to repay another what is his due, but bestowed only because of personal affection or regard or pity or from general motives of philanthropy or charity."

8. *Botchford v. Comm'r*, 81 F.2d 914 (9th Cir. 1936).

9. See *Simpkinson v. Comm'r*, *supra* note 5.

10. T. D. 2090 December 14, 1914.

husband, no services being rendered by the widow, were not deductible as a business expense by the payor. This provision was carried forward in the regulations issued under the Income Tax Acts of 1916 and 1917.<sup>11</sup> However, more than a year later in the regulation,<sup>12</sup> which is a forerunner of the present Regulations 111 § 29.23 (a)-9, the following was promulgated. "When the amount of the salary of an officer or employee is paid for a limited period after his death to his widow or heirs in recognition of services rendered by the individual such payment may be deducted."

In determining the deductibility of the payments to the widow or heirs of a deceased employee, the courts have analyzed these payments as any compensation payment under § 23 (a) of the Code. Is it an ordinary and necessary expense paid or incurred during the taxable year? If it is, is the payment paid to the widow when added to the salary previously paid to the deceased reasonable compensation for services<sup>13</sup> actually rendered; and lastly whether the payment is for a "limited period"?<sup>14</sup>

The court's approach has been to first decide whether the payment is reasonable.<sup>15</sup> Once this has been favorably decided, they next determine whether or not the payments are ordinary and necessary expenses.<sup>16</sup> If the payments are reasonable, they will be deemed an ordinary and necessary expense.<sup>17</sup> The Court in a recent case<sup>18</sup> analyzed the payment made along these lines. Mere reasonableness of the payments of additional compensation is not sufficient; a benefit to the payor is essential for the payment to be ordinary and necessary.<sup>19</sup> "It is not fatal to deductibility that the employer was not legally obligated to make such payment."<sup>20</sup>

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11. TREASURY REGULATIONS 33, Art. 137.

12. TREASURY REGULATIONS 45, Art. 108.

13. W. D. Haden Co., 1946 P-H TC MEMORANDUM DECISIONS 46,089.

14. REGULATIONS 111, § 29.22 (a)-9.

15. Mobile Bar Pilot's Assoc., 35 B.T.A. 12 (1936).

16. *Ibid.*

17. Seavy & Flarsheim Brokerage Co., 41 B.T.A. 198 (1940).

18. Frederick Pfeifer Corp., 14 T.C. 569, 571 (1950). The deceased employee sold his business to the petitioner with the express understanding and condition that he would be president of the petitioner corporation and that in the event of death the widow was to receive a fixed sum so long as she may live. The court held that there was no established pension policy and no showing that the payments were for past compensation and were reasonable in amount. They were paid pursuant to a contract but the contract was not one of employment. Therefore the payments to the widow were not ordinary and necessary expenses of the business of the petitioner. They may have been a part of the business purchased, but if so, they could not be deductible as ordinary and necessary expenses.

19. W. D. Haden Co., 1946 P-H TC MEMORANDUM DECISIONS 46,089, *aff'd*, 165 F.2d 588 (5th Cir. 1948), payment was made only because of the needs of the widow, the husband was paid his complete salary in his lifetime; his brother, the president, did only what he felt was necessary for his moral obligation. In Snyder & Berman, Inc. v. Comm'r, 116 F.2d 165 (4th Cir. 1940), the corporation was not permitted a deduction because the obliged pension to a living employee was paid in the interest of the family, rather than for the business. See Astorian-Budget Publishing Co., 44 B.T.A. 969 (1941), parties concerned over the security of their families and held payments resembled a distribution of profits rather than a pension.

20. Flood v. United States, 133 F.2d 173, 178 (1st Cir. 1943).

An important phrase in Regulation 111 § 23 (a)-9 is "limited period."<sup>21</sup> Does it require a limitation expressed in terms of years irrespective of the number, or does it mean that the actual years must be limited? I.T. 3329<sup>22</sup> seems to indicate that the deduction for the corporation exists so long as the payment is for a "limited period". The Commissioner feels that a "limited period" is two years. In *W. D. Haden Co.*,<sup>23</sup> the Commissioner disallowed the payments because the annual payment of said amount was to be continued indefinitely. The Tax Court found that the payments were to be limited to the widow's lifetime or remarriage and since the petitioner has not shown that the payments in question were to be paid for a "limited period" of time sustained the Commissioner's determination which disallowed a deduction for the payments made to the widow. In *H. T. Cushman Mfg. Co.*,<sup>24</sup> a written contract provided that the corporation pay \$5,000 per annum to its officers' widows, which payments were to last for the lifetime of the widow or a minimum of twenty-five years from the date of execution of the contract. The court held twenty-five years to be a limited period and sustained the deduction distinguishing *Astorian-Budget Publishing Co.*,<sup>25</sup> a case where the payments to the widow were disallowed as a deduction because payments were to be made to the widow or next of kin so long as the widow or next of kin "continued to hold the inherited stock of the taxpayer." The decision was grounded on the fact that the only limitation of time on the payment was the period during which the widow continued to own the stock. The Commissioner seems to be interpreting this phrase incorrectly. There should be a limit as to the time for which a deduction will be granted but not an essential factor for the granting of a deduction. In view of *H. T. Cushing Mfg. Co.*,<sup>26</sup> it would seem that a "limited period" means any period wherein a specified number of years has been designated irrespective of the number so designated.

In a recent case<sup>27</sup> on "limited period" the corporation resolved to pay a pension to the employee and upon his death said pension was to be paid to his widow during her lifetime. The corporation at a later date reworded the resolution and changed the words "unlimited annuity" to a "voluntary pension." The widow reported such payments as income. The petitioner never had any trust or pension arrangement for any of its employees and no employee has ever received such payments. The Commissioner stated that under the facts in this case eighteen months is a "limited period" in which to make payments of the salary the employee was to have received at the time of his death to his widow. The petitioner stated that such payments were in pursuance of contractual obligation and such payments represented

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21. See note 4 *supra*.

22. C. B. 2 153 (1939).

23. See note 19 *supra*.

24. 1943 P-H TC MEMORANDUM DECISIONS 43,475.

25. 44 B.T.A. 969 (1941).

26. See note 24 *supra*.

27. *I. Putnam, Inc. v. Comm'r*, 15 T.C. 86 (1950).

additional compensation for additional service rendered in the past and inadequately compensated during his lifetime and that forty and one-half months is a period which falls within the "limited period" as used in the applicable regulations. The court held these were voluntary payments within the case of *McLaughlin Gormley King Co.*<sup>28</sup> and that after careful consideration of all the facts, a period of twenty-four months is a "limited period" within the meaning of Regulation 111 § 29.23 (a)-9.

The cases do not do very much for determining what is a "limited period" though it seems that the court is applying the term *reasonableness of the payment* and the terms *ordinary and necessary* under § 23 (a) of the Internal Revenue Code to the "limited period." So long as the payor can claim and prove that business benefits flowed to it as a result of the payment in question, the deduction will be allowed. No case gives the reasoning for the period of time allowed, although under the facts of each particular case<sup>29</sup> twenty-four months seems to be the justified period. Since this, as are all deductions, is a matter of legislative grace and does not turn upon general equitable ground<sup>30</sup>, the Congress should have been more specific in its language, especially since after all these years no adequate and definite definition of "limited period" has been determined by the courts.<sup>31</sup>

Whether there is income to the widow or heirs of the deceased employee depends basically upon whether the payment constitutes income to the recipient under the broad definition of income<sup>32</sup> or falls within § 22 (b) (3) of the Code, excluding gifts from gross income. Interpretation of these statutes usually culminates in the typical case of gift versus compensation, applicable to living employees<sup>33</sup> as well as to widows of the deceased employees. Most of the cases which discuss taxability consider the treatment of the books of the corporation and the wording of the resolution as controlling, so that if the corporation takes a deduction treating the payment as compensation, the recipient is to be taxed.

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28. 11 T.C. 569 (1948). The taxpayer was a Minnesota corporation whose president died on July 7, 1939; pursuant to a resolution adopted at the annual meeting of stockholders on November 14, 1939. The remainder of the president's salary for the month of July, 1939 was paid and thereafter \$300 each month through the fiscal year ended September 30, 1943. The court held that payments made by the taxpayer subsequent to November 30, 1941, were not deductible under § 23 (a) of the I.R.C. or the provisions of § 29.23 (a)-9, REGULATION 111. A "limited period" within the meaning of the regulations will depend upon the facts of each particular case.

29. *McLaughlin Gormley King Co.*, 11 T.C. 569 (1948).

30. *Deputy v. DuPont*, 308 U.S. 488 (1940).

31. If I.T. 4027 is to be followed, REGULATION 111 § 29.22 (a)-9 should be revised and there should be no limited period. The payment to a widow which the Commissioner would have taxable should be deductible by the payor as long as the payor is able to prove that under § 23 (a) the payment is a reasonable and an ordinary expense and necessary in trade or business.

32. Section 22 (a) I.R.C., including in gross income "gains, profits and income derived from salaries, wages or compensation for personal services . . . of whatever kind . . . or . . . income derived from any source whatever."

33. *Bogardus v. United States*, 302 U.S. 34 (1937); *Botchford v. Comm'r*, 81 F.2d 914 (9th Cir. 1936); *Bass v. Hawley*, 62 F.2d 721 (5th Cir. 1933); *Weagart v. Bowers*, 57 F.2d 679 (2d Cir. 1932).

I. T. 3329<sup>34</sup>, which permits both a corporate deduction and a gift treatment to the recipient of such payment has for the last few years, been the lighthouse and the beacon to widows. On the basis of this I. T., the Tax Court, in *Louise K. April*,<sup>35</sup> a case which will be discussed after a brief history<sup>36</sup> of the rulings which led to I. T. 3329, ruled in favor of the taxpayer widow.

The only Code provision in favor of a gift to any recipient is to be found in § 22 (b) (3), unless what a widow, heir, or estate receives is a gift within this section, it should not be tax free. In I. T. 3329,<sup>37</sup> the Commissioner was attempting to clarify § 29.22 (a)-2.

The Regulation<sup>38</sup> provides that "so-called pensions awarded by one to whom no services have been rendered are mere gifts or gratuities and are not taxable."

The Regulation stresses the position of the payor and states in effect that if the payor receives services, the Regulation does not apply to the recipient of such a payment and said recipient has taxable income. An example which meets the requirement of the Regulation is the pension granted to retired teachers or their widows by the Carnegie Foundation for the Advancement of Teaching — the teachers performing no services for the benefit of the payor.

I. T. 3329<sup>39</sup> states "that when an allowance is paid by an organization to which the recipient has rendered no service, the amount . . . is not subject to Federal income tax in the hands of the recipient." This type of interpretation is opposed by the decision of the Fifth Circuit Court of Appeals in *Varnedoe v. Allen*.<sup>40</sup> In *Varnedoe*, the taxpayer was the widow of a fireman who during his lifetime was a full-time captain in the fire department in Atlanta, Georgia. After her husband's death, the widow, under an act of the General Assembly commenced receiving payments of \$100 per month. The court held the widow to be taxable on the receipt of the payments and stated, "It is not necessary that the services should have been rendered by the payee. The payor is the one to whom the services

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34. See note 2 *supra*.

35. 13 T.C. 707 (1949).

36. As early as 1914, the Treasury Department issued ruling T.D. 2090 on December 14, 1914 which provided: "Where the monthly salary of an officer or employee is paid for a limited period of time after his death to his widow in recognition of the services rendered by her husband, no services being rendered by the widow, it is held that such payment is a gratuity and exempt from taxation under the income tax law." In a later edition of REGULATION 45, Article 32, 1920 provided: "However, so called pensions awarded by one to whom no services have been rendered are mere gifts or gratuities and are not taxable." In a subsequent ruling issued in 1920; L.O. 1040 (C.B.-3 120 [1920]), the Commissioner held that pensions granted to retired teachers or to widows of teachers by the Carnegie Foundation for the Advancement of Teaching did not constitute taxable income because they were "awarded by one to whom no services have been rendered and who has received no direct benefit from the services rendered".

37. See note 22 *supra*.

38. REGULATION 111 § 29.22 (a)-2.

39. See note 22 *supra*.

40. 158 F.2d 467 (5th Cir. 1946).



must have been rendered." Following this case came more rulings which treated special groups.<sup>41</sup>

In *Louise K. Aprill*,<sup>42</sup> a corporation, after being informed of I. T. 3329 by its auditor, prepared a resolution voting payments to Mrs. Aprill after her husband's death which followed the language and requirements of the I. T. and made her a gift. The payment was voted upon by the board of directors of the corporation and ratified by the stockholders. The Tax Court spoke of the purpose which motivated the corporation in making this gift; the fact that the only services rendered could be those of the husband and then cites I. T. 3329 as the basis of its decision. The Commissioner<sup>43</sup> acquiesced to the holding of this case after the issuance of I. T. 4027, the latest ruling on this subject. This latest I. T. on the subject of payments to widows distinguishes I. T. 3329 and follows the Fifth Circuit's decision in *Varnedoe*.<sup>44</sup> The Commissioner's acquiescence can only mean that for all payments received before January 1, 1951 he will continue to pay honor to I. T. 3329 and *Louise K. Aprill*, but after December 30, 1950, the new Ruling is effective. This type of administrative procedure is good so as to put at rest the minds of taxpayers who follow the Bureau's Rulings and Regulations as the law. To those who feel that I. T. 4027 is incorrect, the Commissioner's acquiescence to *Louise K. Aprill* may be ammunition in any subsequent litigation on this subject. A careful reading of the italics of I. T. 4027<sup>45</sup> as found in footnote number one indicates the basis of the new change in position, which position is legally sounder than that of I. T. 3329.

Whether the payments represent gifts or income cannot be answered by definitions, categories or I. T.'s. Some guidance can be had by distinguish-

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41. I.T. 3653 (C.B.-1 75 [1944]), treated annuities paid under the retirement plan of the city of R to a policeman during his lifetime and to his widow upon his death as taxable to the widow as payment received under an annuity once the consideration paid to the policeman is received tax-free by him prior to his death. The fact that the widow who receives the annuity payment has rendered service to the payor is immaterial in view of the provisions of § 22 (b) (2) of the Code. In 1946, a Special Ruling; 1946 C.C.H. 6241 as issued making it beneficial to be the widow of a governor of Indiana. Annual pensions paid to the widows of the governor or former governors of Indiana pursuant to Indiana's statute which is payable for life or until remarriage were held to come within the category of gift and exempt from income tax under § 22 (b) (3) of the Code. Then in I.T. 3840 (C.B.-7 [1947]), it was held that payments to widows or heirs of a deceased employee under a non-contributory, voluntary death benefit established by the employer represents consideration for services rendered by the employee and constitutes taxable income to the recipient under §§ 22 (a) and 126 (c) of the I.R.C.

In *Mary Sutro v. United States*, (an unreported case), D.C. N.D. Cal., June 2, 1942, a widow included benefits paid to her by Standard Oil Co. of California because of her deceased husband, Oscar Sutro. Benefits were received under a voluntary "Life Insurance and Sickness Disability Benefits" plan. Standard Oil guaranteed payment for life insurance in accordance with the terms of the plan in existence at the time of the employee's death. The court held that though the plan was voluntary, the word guarantee indicated an intent to create an enforceable obligation. The goodwill of the employees and long faithful services on their parts was consideration for the plan.

42. See note 35 *supra*.

43. I.R.B.-24 1 (1950).

44. See note 40 *supra*.

45. See note 1 *supra*.

ing between enforceable and non-enforceable obligations. Where the widow has a vested right enforceable by virtue of a contract the payment to her can not be considered as a gift but must be taxable as income.<sup>46</sup>

The fact that an enforceable contract right presents taxable income to the widow does not mean that non-enforceable obligations or voluntary payments are to be treated as gratuities and non-taxable. The essential problem is to determine the intention of the parties.<sup>47</sup>

Where pension is paid as a result of a uniform plan offered as an inducement to the employees entering into the service of the employer it would seem to represent compensation even though granted without a legal right or moral compulsion.<sup>48</sup> A voluntary payment intended by the payor to represent additional compensation for the services of a deceased employee would be taxable to the recipient.<sup>49</sup>

The Commissioner, in his ever continuing search to raise more revenue and in an attempt to bolster his position in the type of cases discussed herein above, has taxed the recipient of such payments under § 126 (a) of the Internal Revenue Code.

In *O'Daniel's Estate*,<sup>50</sup> the deceased was employed by a corporation which had a bonus plan; however, no employee had an enforceable right to the bonus which was based on the prior year's earnings until his share was designated. The by-laws of the corporation gave the complete details of the bonus plan.<sup>51</sup> No share of the bonus for the year 1943 was designated for the decedent until March 14, 1944, several months after his death which was November 4, 1943. The Tax Court considered and held the payment to be

46. See note 17 *supra*.

47. See note 33 *supra*.

48. Mertins, *Law of Federal Income Taxation*, § 809, p. 392; *Mary Sutro v. United States*, *supra* note 41 (a lighthouseman who engaged in work knowing he would be the recipient of a retirement fund).

49. *Old Colony Trust Co. v. Comm'r*, 279 U.S. 716 (1928); *Noel v. Parrott*, 15 F.2d 669, 671 (4th Cir. 1926) ("It nowhere appears that it was intended as a 'gift' but on the contrary was claimed by the corporation as a salary deduction from its gross income on its income tax return"); see also *Brayton v. Welch*, 39 F. Supp. 537 (D.C. D. Mass. 1941) (where the corporation took the deduction, the court pointed out that generally directors of a corporation may not make a gift of corporate assets, that the stockholders had not ratified the payments and that therefore, the payments were additional compensation and thus represented taxable income to the recipient).

50. *O'Daniel's Estate v. Comm'r of Int. Rev.*, 173 F.2d 966 (2d Cir. 1949), *aff'g* 10 T.C. 631 (1948).

51. See note 52 *infra*. By-law American Cyanamid Corp. (2) (b) that the "Treasurer shall pay and distribute such special fund as follows: (a) To the President . . . to and among those officers and/or employees of the company during such fiscal year whom the President may have designated (which designation may change from time to time) as entitled to participate therein in proportion to the amount of compensation as herein-after defined, received by said person respectively from the company for such fiscal year. (4) The ascertainment made by the accountants or other auditors as aforesaid and the payments and distributions made by the Treasurer, as well as their acts and findings hereunder shall be binding and conclusive on all parties and no one shall have any right to question the same or any part thereof or to any examination of the books, papers or accounts of the Company or to continue with the Company or to maintain any claim against the Company or against any Officer, Director or Employee of the Company or any right to claim except as herein specifically expressed and to the Board of Directors is hereby expressly reserved the right to discharge any officer and/or employee of the Com-

taxable income to the estate under § 126 (2) (1) (A) of the Internal Revenue Code. The petitioner argued that the decedent had no legally enforceable right to the funds paid to the estate and that the decedent's estate did not acquire from the decedent *any right* to receive the payment and that the statute itself imposes the express condition that the amount is taxable to the estate only if the right to receive the amount is acquired by the decedent's estate from the decedent. The Tax Court in finding for the Commissioner grounded its decision on the premise that it was not necessary for the decedent to have had any legal right to the amount and in answer to the petitioner's argument said:<sup>52</sup> "The petitioner's argument misconceives the purpose and effect of the statute. The decedent need not have had a legally enforceable right to the amount at the time of his death."

On appeal to the Second Circuit, petitioner's counsel stressed the importance of the term *right* and its oft usage by the Congress in the enactment of § 126 of the Internal Revenue Code. The term *right* being used five times in subsection (1), three times in subsection (2), and three times in subsection (3).

The Second Circuit's interpretation of "if the right to receive the amount is acquired by the decedent's estate from the decedent" completely ignores the commonly accepted definition of the term "right" as well as its frequent use by the Congress and interprets the term "right" as not being a legally enforceable right and affirmed the Tax Court.

The petitioner in *O'Daniel*<sup>53</sup> was not arguing that the bonus payment was a "gift" but merely that the payment was not taxable as income within the present Code provisions and that the mere fact that the income may escape taxation does not impel its inclusion in taxable income.

Prior to the amendment of § 42 by the Revenue Act of 1934, the courts had held that income of a decedent on a cash basis accrued prior to his death did not constitute income to his estate when collected.<sup>54</sup> The accrued item was not income to the decedent since it had not been received. Immediately upon his death the item was considered a corpus item of the estate, having a cost basis of the value of the item at the date of death. A taxpayer on the accrual basis was in a different situation, since all items accrued prior to death were includible in the decedent's last return on the basis of his accrual method of accounting.

The Revenue Act of 1934, in an attempt to overcome this gap in the income tax law, amended § 42 of the Internal Revenue Code to pro-

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pany and to withhold, in whole or in part, the participation in any of the above payments and distributions which any such officer and/or employee of the Company would or might receive.

52. 10 T.C. 634, 639 (1948).

53. See note 50 *supra*.

54. *Nichols v. United States*, 64 Ct. Cl. 241 (1947); *Jackson B. Kemper, Admin.*, 14 B.T.A. 931 (1928); *William P. Blodgett, Exec.*, 13 B.T.A. 1234 (1928).

vide that whether a taxpayer decedent was on a cash or accrual basis, all items of income were to be accrued in the decedent's last return.<sup>55</sup>

Under § 42, as thus amended, it became important to determine what items were to be considered accrued; and the word accrued was given a very broad expansion. As a result of the 1934 law hardship resulted in many cases through the pyramiding of large amounts of income in the decedent's last return which ordinarily would be receivable over a period of several years.

The purposes of the amendments embodied in § 134 of the Revenue Act of 1942 was to prevent the escape of income which prior to 1934 could escape taxation, but at the same time to lighten the burden so that such amounts could be taxed to the same extent as if the decedent had remained alive and received them.

A cash basis taxpayer's final return no longer included accrued items, but such items referred to in § 126 as "income in respect of a decedent" were made taxable, when received, to the estate or person entitled by devise, bequest or inheritance to the particular income item. Not every conceivable item which might result in gain to the estate was included in the cash basis taxpayer's final return under the accrual provisions of former § 42 of the Internal Revenue Code.

The terms of coverage of § 126 in subdivision (a) (1) is "all items of gross income in respect of the decedent" and the terms of incidence in items (A), (B) and (C) thereunder refer to the taxable entity or person to whom "the right to receive the amount is acquired."

If, in accordance with the canons of statutory construction, we look first to the statute itself for its meaning, we find that the statement of the "general rule" in § 126 (a) (1) furnishes a significant hint as to the coverage of the phrase "amount of all items of gross income in respect of a decedent" in a careful choice of words in subdivisions (A), (B) and (C). Each of these subdivisions defines the person taxed by reference to "the right to receive the amount" (obviously "of items of gross income in respect of a decedent") instead of simply naming the classes as receiving or collecting the gross income. The same phrase, "right to receive the amount", is identified as a right acquired by the decedent in § 126 (a) (3) and the same identification is implicit in § 126 (a) (2). Such a particular and technical phrase would not have been used throughout all of § 126 (a) except for some limiting purpose. It is suggested that this purpose is the distinguishing of *rights to income* as a kind of legal property.

Income within the meaning of the Sixteenth Amendment is the fruit that is born of labor, not the potency of fruition. A claim that is

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55. 48 STAT. 680c § 42 (1934).

conditional or contingent is to be taxed when shorn of its conditions or contingent quality and becomes unconditional or absolute.<sup>56</sup>

The second step in the canons of statutory construction is the intent of Congress in enacting § 126.

Since the Revenue Act of 1934 the revenue laws have contained provisions including in the income of a decedent for the period in which falls the date of his death all income accrued up to the date of his death not otherwise properly includible in respect of such period or a prior period. While such income should be subject to income tax, hardship results in many cases including in the income for the decedent's last taxable period amounts which ordinarily would be receivable over a period of several years. This section changes the existing law by providing that such amounts shall not be included in the decedent's income but shall be treated, in the hands of the person receiving them as income of the same nature and to the same extent as such amounts would be income if the decedent remained alive and received such amounts . . . *The right to income is treated in the hands of the decedent differently from his other property*, and when his estate or his legatee takes his place with respect to this income, it is proper to *treat this right* in their hands in the same manner as it would be treated in the hands of the decedent . . . .

. . . The persons who are placed, with respect to such amounts, in the same position as the decedent are the decedent's estate, which in the great majority of cases will receive such amounts, and, if the estate does not collect such amounts *but distributes the right to receive such amounts* to the heir, next of kin, legatee or devisee who inherited or was bequeathed or devised *such right* such heir, next of kin, legatee or devisee. Also placed in the same position as the decedent with respect to such amount are those *who acquire the right* to such amounts by reason of the death of the decedent . . . .

. . . Another example is the case of the partner who contracts in the partnership agreement that his interests in certain partnership assets shall pass to the surviving spouse in exchange for payments to be made by them to his widow. On his death the payments by the surviving partners shall be included in the widow's income to the extent they represent the gain on such sale. If the payments are to be made to the widow as trustee for minor children, and the *right* to receive such payments is transferred to the children upon their majority, the children are within the provisions of section 126 (a) (1) as receiving the right to such payments by reason of the death of the decedent . . . Thus if the right to receive the income is disposed of by a gift, the donor must include the fair market value of *such right* in his gross income in view of his benefit from *such right* . . . .

. . . Subsection (a) (3) of section 126 provides *that the right to receive an amount* described in subsection (a) (1) shall be treated in the hands of a person described in that subsection if it had been acquired in the transaction by which the decedent acquired such

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56. *United States v. Safety Car Heating & Lighting Co.*, 297 U.S. 88 (1936).

right, and shall be considered as having the same character it would have had if the decedent had lived and had received such amount. This provision is designed to place the person described in subsection (a) (1) in the same position with respect to the nature of this income as the position the decedent enjoyed. (*italics added*)<sup>57</sup>

From this report it can be seen that Congress intended to tax all income, and that the purpose of this new section was to prevent the hardships which result from including all of the income of the decedent in his last taxable period, amounts which would be receivable over a period of several years. Since this was the purpose as spelled out in the Report of the Committee on Finance, Congress had to tax to the decedent's estate, heirs, next of kin, legatee or devisee any *right* to income received by them through the decedent. The Congress used this word "right" as a well chosen word to describe what the estate, heirs, next of kin, legatee or devisee received from the decedent.

If income is received by an employee during his lifetime from an employer, without a legal right, by the weight of the cases the payments are considered as taxable income to the employee.<sup>58</sup> An employee has no right to receive bonuses, Christmas gifts or other benefits from an employer even though economically and morally he may be considered entitled to the bonus or other benefits. In any interpretation of § 126 we can not consider the use of the word "right" in the same light as entitlement to or some moral obligation.

When a payment is made after the death of the employee, it is received by the recipient widow, heir, next of kin, legatee or devisee under § 126 (a) of the Code. That Congress intended a "right" to mean a legal right can be seen from the example of the minor child in the Senate Finance Committee Reports, who receives a right from her father and the treatment of the transfer of a right under § 126 (a) (3) which requires a person who transfers such right to include the fair market value in his gross income plus the amount by which any consideration received on such transfer exceeds the fair market value of such right. Clearly Congress must have had in mind a *legal right*, something which could be sold and which would be bought. Where the payment to be made is voluntary and at the option of the payor, there is no right which a bona fide purchaser would be willing to buy because of the speculative nature of what he would be buying.

The Commissioner in his Regulations<sup>59</sup> which interpret § 162 (b) of the Internal Revenue Code states as follows: "the term income which becomes payable means income which the legatee, heir, or beneficiary has a present *right* whether or not such income is actually paid. Such *right*

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57. Report of the Committee on Finance, SEN. REP. NO. 1631, 77th Cong., 2nd Sess., 100-112, C.B.-2 504, 579-581 (1942).

58. See note 47 *supra*.

59. REGULATION 111 § 29.162-2(b).

may be derived from the directions in the trust instrument or will to make distributions of income at a certain date or from the exercise of the fiduciary's discretion to distribute income, or from a recognized present right under the local law to obtain income or compel a distribution of income . . . .

. . . . Example (1) . . . . Under the terms of the trust and the local law (which allow accumulations) the income of the trust for the period of 12 months ended June 30 of each year is accumulated and the beneficiary has *no right* to such income until the last day of such period (June 30)." (italics added)

In the Commissioner's Regulation just cited the word "right" is given the meaning of a *legal right*, the only meaning such a limiting word can have in a technical statute such as the Internal Revenue Code.

If the word *right* has so technical a meaning under § 162 of the Code how can the word *right* have *no legal* meaning at all under § 126 as the Commissioner contends and the Tax Court has ruled?<sup>60</sup> Surely the use of a technical word in the income tax laws should have the same meaning wherever met in the Code.

The third step in the canons of statutory construction is that of looking to other courts for the interpretation of a word. In *Jack T. Messing*<sup>61</sup> the deceased was employed by Arthur Beir and Co., Inc., as a confidential bookkeeper and cashier at a salary of \$7500 per annum. For three years prior to his death Mr. Messing received a bonus of \$24,000. Mr. Messing died on August 22, 1944 and his weekly salary was paid for the month of August and then stopped. In December, Mr. Sidney Beir, the president, paid Messing's estate the sum of \$24,000 with a personal check which the petitioner claims was a gratuity. There was no prior arrangement or agreement; there was no plan; in some years gratuities were paid to employees, in others no gratuities were paid; the percentage of profits did not determine the amount of gratuities. The president's two brothers who were stockholders and officers of the corporation died and their widows were not paid any bonuses. Mr. Sidney Beir made the gratuity because he felt something should be done for the widow. The issue before the Tax Court was whether the bonus should be included in the gross estate of the deceased. The estate tax is an excise tax upon the privilege of transferring or transmitting property by reason of death, and is not a tax on property itself; so that unless there was something which passed from the decedent on death, there was no transfer and nothing which could have been subject to the excise tax for the privilege of transfer. The court in deciding, said that the *right* to receive payment was of primary importance. "There was no legal obligation to pay, no prior arrangement or any specific percentage, nor specific agreement. The

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60. See note 52 *supra*.

61. T.C.M. D.9C. No. 16770, August 18, 1948.

willingness to pay the bonuses and the amount thereof was entirely within the discretion of the employer, as a matter of law and fact at no time did the employee have an enforceable right or claim for the bonus."

At no time, either before or after death, did the employee have an enforceable right or claim for the bonus, and at no time was there any claim for a bonus of any value whatsoever.

The estate tax and § 126 (a) are so closely related that it is impossible to consider the "right to receive payment" under the estate tax to mean anything different under § 126 (a). This is one instance where the two can not possibly be considered as being mutually exclusive. Section 811 taxes all the property which the decedent had an interest in, whereas § 126 (a) taxes only that income to which the decedent had a right at the date of his death. If the expectation or hope that a bonus would be paid is not sufficient basis for taxability under § 811, such expectation or hope should not be taxable to the recipient under § 126 of the Code.

Income of a decedent which is uncollected at the time of his death or, if the decedent is on the accrual basis, income which had not accrued at the time of his death in the normal accounting sense and which for this reason is not includible in the decedent's final income tax return is nevertheless a property right forming a part of the gross estate under § 811 for the purpose of the estate tax. As Congress did not wish to subject to income tax the amount of additional estate tax attributable to the inclusion in the decedent's gross estate of § 126 (a) income items, the proportionate amounts of the additional estate assessed on such income is allowed as a deduction to the § 126 (a) (1) recipient at the time he includes the income in his own return.

This shows the relationship between the two sections and the fact that there is no mutual exclusiveness between the §§ 811 and 126. Therefore if an item is not includible under the estate tax law because it is not legally definite enough, how could such an item be considered as income under § 126 of the Code? If such were the case, no deduction would be allowed for the estate tax because such items were not a right includible in gross estate and § 126 (c) would in many cases have no function.

The following language of the Senate Finance Report lends force to the thought that the relationship of § 811 to § 126 and ties the term *right* in § 811 to § 126 and urges the same meaning in both instances.

Subsection (c) of Section 126 provides that the recipient of income in respect of a decedent may deduct that portion of the estate tax levied on the decedent's estate which is attributable to the inclusion of the *right to such income* in the decedent's estate.<sup>62</sup>

In *Estate of Basch*<sup>63</sup> the Commissioner's finding of taxable income

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62. See note 57 *supra*, at 504, 582.

63. 9 T.C. 627 (1947).



to the decedent's estate was correct because the decedent at the time of his death by his employment contract had a legal right to a percentage of the profits.<sup>64</sup>

In the most recent case in this field, the Estate of Edward Bausch,<sup>65</sup> the Tax Court determined that the payments received by the estate were taxable under §§ 126(a) and 22(a). The petitioner, on appeal, argued that this case was distinguishable from *O'Daniels Estate*, where the deceased had a right at his death subject to § 126(a). Here the decedents at the time of their death had already been paid all the money they could have expected for their prior services. In order to get any more they would have had to continue to live and perform services, or at least retire on a pension. Such payments as had been made in the past to the heirs and estates of deceased officers and employees were spasmodic, irregular and in varying amounts. There was no regular practice to make such payments. No rights whatever to any further payments passed from these decedents to make such payments. The Second Circuit in affirming did not discuss the meaning of the term "right" in § 126(a) and stated that "though the correctness of the ruling as to widows in I. T. 3329 would seem doubtful if applied in all cases, it is unnecessary to consider under which circumstances sums paid to a widow or to other persons might be gifts and nothing more, for the payments here were by way of compensation rather than gifts and therefore includible under section 126."<sup>66</sup>

It seems that the Second Circuit is firmly entrenched in its acceptance of the Commissioner's argument under § 126(a) as to its application where the recipient of the payment is the estate and also indicates as possible a similar holding in a case where the widow is the recipient. Though the court's statement was only a dictum, it may be support for the new I. T. 4027 which holds such payments as income.

The taxpayer in this type of case should take his appeal to another Circuit or perhaps try the District Court and the Court of Claims. The theoretical approach to § 126 should bring a decision in favor of the taxpayer.

The Second Circuit in its desire to seek revenue can not see income untaxed unless it is definitely and clearly spelled out to be a gift. This is not so. This is merely one case in which Congress failed to provide for this type of a situation.

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64. The contract provided that the decedent should receive "... in addition to such salary, further compensation equal to eleven per cent (11%) of the net annual profits (before federal income and excess profits tax) during such term, of the employer as ascertained by its Certified Public Accountants. . . ."

65. 14 T.C. 1433 (1950). The deceased had no widow but the Company paid his monthly salary for twelve months to his estate. Similar payments had been made in the past to the heirs directly or the estates of deceased officers. However, there was no agreement between the Company and the decedent. No resolution was ever adopted regarding the payments and the corporate return showed this expenditure as a deduction.

66. *Bausch's Estate v. Comm'r*, 186 F.2d 313, 314 (2d Cir. 1951).

In *Helvering v. Enwright*<sup>67</sup> the Supreme Court in a footnote took time to add the following quotation: "It is immaterial that all possibilities of escaping an income tax is not barred as for instance the increased value of asset items in the estate return act 113(a)5 . . . the entire field of proper legislation (need not) be covered by a single enactment."<sup>68</sup>

The new I. T. 4027<sup>69</sup> is a good law, following the weight of the cases, some of which have been mentioned herein, and its modification of I. T. 3329 is valid and justified. However, I. T. 3329 was promulgated in 1939 which was before the enactment of § 126(a) and to the extent to which I. T. 4027 corrects the old I. T., they both run afoul of § 126.

If the Commissioner feels that I. T. 4027 should be the law as he has indicated and § 126(a) is not a haven for recipients of such payments, he should go to Congress and have I. T. 4027 legislated and § 126 reinterpreted and reenacted.

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67. 312 U.S. 636 (1941).

68. *Id.* at 644-645.

69. See note 1, *supra*.